

FROM THE ACQUISITION REFORM OFFICE . . .

Rapid Improvement Team Develops Innovative Contract Incentives

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DOD's Change Management Center is conducting a rapid improvement campaign to develop innovative contract incentive provisions for use in future DOD procurements. DOD and industry are involved in thousands of business relationships each year. All too often, however, the factors that motivate one party to succeed in a business relationship are not fully understood by the other party.

Mutual understanding of the fundamental business relationship underlying a particular contract and its specific incentives can motivate both the government and industry to achieve contract performance results. Contract incentives that can be tailored for each business relationship are sparse, and the use of commercial-style contract incentives is correspondingly narrow. To address this shortfall, the Deputy Under Secretary of Defense for Acquisition Reform and the Director of Defense Procurement partnered to initiate a rapid improvement team (RIT) engagement, Oct. 4-5, 2000, at the Defense Systems Management College, Fort Belvoir, VA.

Team members, nominated by senior leadership based on their involvement and domain expertise, included organizational representatives from the Office of Federal Procurement Policy, the Office of the Secretary of Defense, military Services, other Defense agencies, and industry. In addition, functional experts from program executive offices, installation management officers, finance and accounting offices, and contracting officers were included on the team.

The RIT addressed policy, financial, and program issues associated with three specific contract incentives: share in savings (SIS), fast cash, and tournament contracting. Additionally, the RIT developed the framework for these innovative incentives with guidance for their application, draft administrative processes, and sample contract language that can be tailored to future contracts. Through the RIT's efforts, metrics were also developed to assess overall effectiveness of the identified contract incentives. A summary of these incentives is provided in the following paragraphs.

SIS

A SIS incentive encourages contractors to apply ingenuity and innovation to complete the work quickly and efficiently and share in the savings attributed to their planning and execution.

Target of Use

- Best used when return on investment is big enough to make this a viable business proposition for the contractor.
- Shifts the risk from government to contractor with commensurate opportunity for contractor reward for successful performance.
- Requires partnership approach between government and contractor because of risks involved.
- Allows contractor to apply ingenuity and innovation to efficiently deliver the requirement instead of dictating the government-preferred approach.
- Fixed-price contracts place emphasis for results in schedule and program costs on contractors if they wish to increase profits.
- Performance incentives can be added for particularly critical areas.
- Types of SIS situations are *revenue enhancement*, where an agency seeks to enhance revenue by collecting taxes or user fees; *cost avoidance*, where an agency wants to reduce a net expenditure by cutting the cost of an operation, and the government automatically shares in any savings; and *agency reward contracts*, where an agency wants to reduce a net expenditure and keep the savings for its own use.
- SIS contracts can also guarantee no fee, promising payment only when benefits result from the contractor's efforts. The offeror pays upfront costs and gets nothing for failure.

Elements of Use

- Must be able to establish baseline and methodology for calculating benefit pool. The baseline and methodology *do not* need to be perfect as long as there is advance notice of the baseline and methodology, contractor buy-in, and consistent post-award application.
- The government identifies a monetizable benefits pool that successful contract performance will achieve. The benefit pool may be "on-budget" (e.g., reduced operations and maintenance spending or reduced spare-parts procurement) or "off-budget" (e.g., improved system performance, decreased down-time).
- The government then pays the contractor an agreed-upon portion of the monetizable benefits earned under the contract. In a 100-percent SIS contract, the contractor's entire payment is a percentage of benefits realized. Alternatively, the contractor may be paid a base fee or profit plus a (smaller) percentage of the benefits.
- In a reinvestment variation, there can also be an election by the contractor to reinvest all or part of that savings into the product, program, or service. In that event, the contractor's contribution is matched by the government at a specified share. The effort is subject to mutual agreement between the parties, but the sharing is pre-established as a part of the incentive plan.

Pros

- The government pays only for results; a level of effort isn't enough.

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- The incentive contributes to affordability from the standpoint of developing initiatives that would reduce overall instant contract or program life-cycle costs.
- Allows the contractor to decide whether savings are taken as profit or reinvested with the benefit of an added portion from the government. If reinvested, the contractor has an opportunity for product enhancement that might not otherwise have been funded. The result could provide an improved product or competitive advantage for the contractor in future competitions.
- Contractor strongly incentivized for results and penalized for poor performance—the better the results, the higher the payment to the contractor. At the extreme, the contractor is not paid at all if the contract achieves no benefits for the government.
- Contractor incentivized to deliver “A” team and innovative solutions to problems.
- Focuses the government on results, not process.

Cautions

- The government and the contractor must agree if there is a decision to reinvest.
- The financial mechanics may be difficult to arrange because of comptroller process issues and current appropriation laws.
- May be difficult for small businesses to participate as primes (this form of contract may often require upfront contractor investments that are paid back only during out-years).

Fast Cash

Using this incentive, the government conveys the desired outcome to the contractor in terms of performance and/or cost. Contractors convey minimum expected return and the basis for such. The government and contractor then partner in developing the price and payment terms that best meet each party's expectations.

Target of Use

Should be considered for use when funds available to government may not be enough to cover anticipated price using normal contracting procedures.

Elements of Use

- Uses cash flow to drive faster performance and/or lower total price.
- Requires an open, trusting relationship between parties.

Pros

- Can lead to a contract that will have the greatest chance of successful performance.
- By speeding up cash flow to contractor, the government may execute contract at a lower price. This could make an unaffordable acquisition more affordable.

Cautions

- Requires successful collaboration and open communication.
- Cultural impediments may make implementation difficult.
- Motivations of each party must be clearly understood.
- Pricing arrangement may require higher authority approvals.

Tournament Contracting

Competition is structured as an auction and prototype competition, with the winner awarded a “prize” for the best product. Auction component consists of participants paying a fee for entering the tournament, which could be used to defray the cost of the prize or offset the cost of conducting the competition.

Target of Use

- Research and development, and
- Opportunities for commercial application of the developed product.

Elements of Use

- Government commits to paying the research tournament winner a prize.
- Selection of winner is based on specified priorities established by the government and included in the Request For Proposal.
- Quality of design is most important.

Pros

- Promotes innovation by offerors.
- Provides firmer cost estimates for equipment because costs would be based on completed hardware versus conceptual hardware estimates.
- Prototype can be evaluated and its uses clarified before production dollars are committed.
- Supports thrust toward modeling and simulation of new systems.
- Requires less government oversight because the offeror has already developed the item and is offering it at a fixed price to the government.
- Contractors can specify within their proposal what they consider to be appropriate rewards or fees for alternative or additional performance goals.

Cautions

Determining the prize requires careful consideration and evaluation:

- Award level must be based on value to the government.
- Award level must be based on a formula.
- Award level must incorporate other determinants.